

*Mr Gordon*

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*Exhibit M-22-8*

**Submission**

*7/6/58*

TO THE

**ROYAL COMMISSION ON ENERGY**

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CANADIAN DEVONIAN PETROLEUMS LIMITED

CANADIAN HOMESTEAD OILS LIMITED

CONSOLIDATED EAST CREST OIL COMPANY LIMITED

CONSOLIDATED MIC MAC OILS LTD.

HOME OIL COMPANY LIMITED

MERRILL PETROLEUMS LIMITED


OKALTA OILS, LIMITED

WESTBURNE OIL COMPANY LTD.

X WESTERN DECALTA PETROLEUM LIMITED

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MONTREAL, JULY 22, 1958



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SUBMISSION  
TO  
THE ROYAL COMMISSION ON ENERGY  
  
SOME OBSERVATIONS  
ON THE  
INDEPENDENT OIL INDUSTRY IN WESTERN CANADA



## SUMMARY

1. The oil industry has become one of the largest industries in Canada within the last ten years.
2. The size of the job performed and yet to be done is immense.
3. The contribution by the independent oil industry has been substantial
  - (a) They have paid \$158,000,000 for Crown oil rights in Alberta.
  - (b) They have drilled 50% of the wildcat wells.
4. The Canadian independent oil producing companies are in the best position to represent the essentially Canadian point of view of the oil producing industry in Western Canada.
5. Canadian participation in the initial stages of the new oil industry in 1947 was at a serious disadvantage due to the absence of local technical and financial experience in the oil business.
6. In the initial enthusiasm, there was a surge of equity financing of new independent oil companies in 1947 to 1952. This is the origin of the majority of the existing independents.
7. Since then it has become increasingly difficult to raise equity finance; fewer and fewer independent companies are being registered; more and more are being merged.
8. Smaller independent groups of oil investors, or oil companies, rely upon adequate incentives for individuals to invest in the oil business. These incentives are insufficient at the present time.
9. Only sizeable independent oil companies are in a position to:
  - (a) Attract financing
  - (b) Attract qualified management
  - (c) Obtain adequate exposure to oil finding.

10. The activities of Canadian independent oil companies are highly sensitive to any reduction in allowables; many have restricted means of financing except through debt secured by oil production.
11. Land, enlarged geological and geophysical knowledge, new techniques, trained Canadian personnel are now available for a thriving independent industry.
12. The continued generation and well-being of Canadian independent oil companies will depend upon:-
  - (a) Incentive tax legislation
  - (b) Attracting equity financing and individual risk money
  - (c) Greater facilities for long term financing
  - (d) An assured and growing market for as much crude oil as can be properly produced.

## INTRODUCTION

The independent Canadian oil producing company may be defined as one which is wholly or very substantially dependent for its revenues and development program upon properties held in Western Canada. This is in contrast to a major international company (whether integrated or not) which derives the greater part of its revenues from the development of properties with great resources from many parts of the world. There is a rapidly growing third important category. A number of independent companies from the U.S.A. are setting up organizations in Canada, as oil becomes more and more expensive to find in the U.S.A. A purist will have little difficulty in finding borderline cases which fall part way between these extremes, but the great majority of companies fall clearly within one or other of these three categories.

This review describes in some detail the range of activities of the independent producing companies; their genesis, merger and decess; their special investment appeal to the public; their special opportunity for an individual Canadian operator or group of individuals of initiative; their very particular fiscal problems in relation to the proration and market demand; their taxation problems; their contribution to the industry and their relationship with the major international oil companies operating in Western Canada.

## PROBLEMS OF THE INDEPENDENT INDUSTRY

Now that ten years have passed since the discovery of Leduc it is possible to examine the statistical results of this period and to examine the functioning of the independent petroleum industry.

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Y  
Authorities agree that foreign capital has played a dominant and highly necessary role in the development of the Canadian oil industry. Foreign capital investment in the oil industry alone contributed \$1.3 billion for direct investment from 1946 to 1956. As a result it has been estimated that 80.1% of the industry is controlled by foreign capital. It is of significance that in 1947 the international oil companies were firmly established world-wide and able to move into Alberta rapidly. This has had a far reaching effect upon the efforts of Canadian independents in their own country. With their vast financial backing already established the international oil companies were able to take full advantage of the land tenure position in Western Canada. In the light of all their experience they were quick to appreciate the possibilities of a rich oil province in Western Canada and obtained great tracts of land under favourable exploration conditions. The results of their keen foresight are evident. By contrast, in the discovery days in the U.S.A., there were no major companies, nor was the majority of the land owned by Government. Companies which are now majors were themselves in their infancy.

Against this background it is not surprising that Canadians, who for the most part were quite unfamiliar with oil booms, unfamiliar with oil land values, lacking technical management and unable to raise the large amounts of risk money for exploration, played a secondary role in the development over these past ten years.

Now, however, Canadians are becoming more and more knowledgeable about their own oil industry, and a good reservoir of technically trained men is becoming available. Companies can now be formed under good local management provided adequate incentives are assured, and it is our belief that an aggressive Canadian independent industry should be encouraged to grow, fostered by circumstances which are controllable within its country in the same way that its counterpart is fostered in the U.S.A. by greater facilities for long term financing, incentive tax legislation, quotas and tariffs.

How far the industry has been concentrated in a few hands is demonstrated by the following percentages of ownership. We have estimated that eight major companies own:-

- 55% of the gas reserves in Alberta as of December 31, 1957
- 65% of the oil reserves in Alberta as of December 31, 1957
- 58% of the oil production in Western Canada in 1957
- 56% of the oil wells in Alberta as of December 31, 1957
- 45% of the land under lease or reservation in Western Canada as of December 31, 1957
- 40% of the oil pipelines in Canada as of December 31, 1957
- 65% of the gathering lines in Canada as of December 31, 1957
- 79% of the refineries in Canada as of December 31, 1957

## HISTORICAL

Drilling for oil and gas in Alberta began seriously in 1914. Much of the early work was done by companies in Turner Valley and they obtained their finance from the public by the issue of shares to small speculative investors.

Many of these scattered interests were consolidated for the most part by one major company in the years 1920 to 1930.

Out of the discovery of substantial oil reserves at Turner Valley in 1936, numerous small companies again sprung up to develop small leases. Public financing on a company basis was not too successful and individual wells

were financed by the sale of "net royalty interests". This, in effect, entitled the holder of a 1% net royalty interest to 1% of the net proceeds of production after payment of the gross royalties and operating expenses. In the event that sufficient royalties could not be sold to individual holders, it was not unusual for one of the major companies to purchase those unsold with the stipulation that if oil and gas were discovered that a crude and natural gas contract would be entered into with that company. The promoter and developer of the well usually retained as his profit, a gross royalty in the well together with the operating rights which entitled him to a fixed fee for operating the well. This method of financing was employed quite successfully until 1942 at which time new income tax legislation (introduced as a result of a successful appeal by B & B Royalties Limited in the Court of Exchequer) had the effect of taxing income accruing to royalty holders both in the hands of the trustee and the hands of the royalty holders. This change in legislation prohibited the raising of money to drill wells on a royalty basis with the result that most of the drilling during the early and middle 1940's was by major oil companies and a few of the stronger independents. This was one instance of taxation working to the disadvantage of the independent.

During these early years exploration costs, particularly drilling, which did not result in production, could not be charged against income for tax purposes. The producer could not sustain many of these losses without ceasing exploration.

In 1943, the Federal Government formed a company known as Wartime Oils Limited to expedite development of Canadian oil sites by financing drilling on proved lands believed capable of marginal production. Wartime Oils Limited advanced the full drilling cost to operators who bore only the cost of testing the well and equipping it for production. The liability of the operator in respect of the advances received was limited to their repayment from production together with a small royalty to Wartime Oils Limited based on the amount of funds advanced. Without this assistance from the Federal Government it is unlikely that the independent operators could have borrowed or raised the money necessary to drill even proven leases. During this period of time, several of the

major companies did engage in drilling activities but primarily they were using marketing profits and also, due to high income taxes in effect at the time, were being financed directly by the Federal Government as they were permitted to deduct their drilling costs from taxes otherwise payable.

Since the discovery of Leduc in 1947 the financing of the independent oil companies may be roughly divided into four phases:

- (a) Promotion of a large number of small companies and the selling of equity in these companies - 1947 to 1952.
- (b) The realization of the possibilities of the production loan technique referred to in Appendix I - 1949 onwards.
- (c) The sale of convertible debentures, which permitted the investor first, to recover his investment without taxation; second, to earn some interest on his investment; and third, to have the option to acquire equity in the company at a reasonable price if the company was successful - 1952 to 1954 onwards.
- (d) The sale of preferred stock and first mortgage bonds to institutions, such as insurance companies, pension funds and banks in the United States - 1950 to 1955; and from 1955 some minor sales have been made in Canada.

The ease with which equity financing has been done reached its peak in 1950 to 1952. Since that time it has become increasingly difficult to finance independent companies through the sale of equity stock, although some established independents refinanced in 1957.

A drying up of risk capital has arisen from regulation of the Stock Exchanges, limitations on the use of credit in the purchase of securities and the high taxes on personal incomes. It has also made equity financing difficult and costly.

In reviewing 33 companies, which are most active in the oil business, a wide variety of policies can be detected. Clearly there is no prescribed road to success. However, for the sake of clarity some attempt can be made to classify the results of the effort of various types of companies: -

- (a) There are those who acquired blocks of land of sufficient size and have had the good fortune to have oil found on them strictly as a matter of luck. The value of the original equity put into these companies has multiplied several times to the great benefit of the shareholders, and as a result aggressive independents became established.
- (b) There are those who have concentrated upon the building of production revenue out of which they expect to continue an increasing amount of exploration in the future.
- (c) There are those, who had established sources of production revenue from development in Turner Valley and had formed a nucleus of sound technical management, and as a result of this have made substantial discoveries based on good geological thinking.
- (d) There are those who formed companies, installed good management and proceeded immediately into the exploration field, some of which have had outstanding success.
- (e) Finally, there are those who used their capital funds for exploration, without any particular direction or knowledge.

In all these cases there have been successes and in all there have been failures. The failures predominate in the last category.

Following the discovery of Leduc in 1947 the public was again attracted to the purchase of shares in the Western Canadian oil business. In Canada, in contrast to the United States, there is little or no tax advantage to an individual who becomes involved in the drilling of oil wells. Because of these barriers, there has not been the great number of independent operators such as came into existence in the United States during a similar period. Most of the present Canadian independent industry is made up of independent companies which did equity financing mainly in 1950 to 1952.

Thereafter more independent companies participated in the acquisition of proven acreage and more of them turned to the banks to borrow the funds necessary for these acquisitions. Production loans were made on the security of the wells drilled or acquired and repayments were made out of the proceeds of production from the wells on these properties. By 1956-1957 the ability of the banks to lend was heavily curtailed and this had an immediate restrictive influence on the activities of the independent companies who were buying proven production. Since that time, the "credit climate" has improved slightly.

There is a great incentive to convert the short term production loan to a long term mortgage or debenture. The ability to do this provides a great stimulus to the growing independent. The inability to do it, either through market conditions or lack of size, leaves the company in a vulnerable position; if, coincidentally, allowables are cut, the independent is indeed in a serious position because the company guarantees the bank loans. There are instances in Calgary where not only drastic reductions in personnel have had to be made in order to maintain bank payments but all exploration in these companies has ceased.

#### NUMBER OF INDEPENDENT OIL COMPANIES

The total number of independent oil companies listed in the "Financial Post Survey of Oils", of all shades of activity is 365. Of these, 269 are insignificant; 63 are small but significant; 33 are relatively large, active and aggressive.

The total number of independent companies who have come into being and subsequently ceased to function is about 2,200; of this about 11% have ceased to function because they have merged.

Trinidad is another oil country where the independent industry has passed through various phases. It could well represent, on a small scale, a future pattern for Canada. In that country where production in 1920 was

1,000,000 barrels per annum and has stabilized at about 21,000,000 barrels from 1940 onwards, 157 independent companies were formed of which 10 were active in 1950 and 5 were paying dividends. Of these 5 only 3 now remain independent. The two largest independent companies were absorbed; the first, United British Oilfields into Shell Oil in the 1920's and the second, Trinidad Leaseholds was sold to Texaco for about \$176,000,000 in 1956. British Petroleum, Texaco and Shell are now grouped together to form Trinidad Northern Areas.

The question arises whether in fact Western Canada is following this pattern. An examination of the records of the Alberta Registrar of Companies shows that the number of companies formed in Alberta reached a peak in 1952 and has since shown a steady decline (see attached graph). Registrations from outside the Province have shown an upswing in the past year due probably to increasing participation by independent oil companies from the United States. During 1957 10 U.S. independent oil companies started business in Western Canada. In the first four months of 1958, the same number of companies, namely 10, started business in Western Canada.

Our concern is that the local Canadian independent company may be supplanted unless it is given the same advantages as its counterpart in the United States.

#### THE IMPORTANCE OF SIZE FOR AN INDEPENDENT OIL COMPANY

The techniques of assessment, evaluation, exploration, engineering, geology, financing and general development of oil properties demand highly qualified, trained and experienced personnel. There must be certain incentives to draw suitable men away from the relatively assured employment of a major company, and they will only be attracted by a vigorous and growing independent industry.

During 1947 to 1952 the industry was both vigorous and growing and size was not too important. Now, however, size has become important. To attract substantial finance, not only is a record of success of management for oil finding or a record of successful oil purchases necessary but now size

and backing are essential. Financing from insurance companies or pension funds or backing from large financial institutions comes more easily when the applicant is searching for several million dollars backed by adequate production. Small companies of less than, say, 1000 barrels of oil per day find it exceedingly difficult if not impossible to raise funds and have been forced to merge in some cases.

## EFFECT OF ALLOWABLES AND MARKETS

Since 1947 the independent industry has invested more than \$158,000,000 in proven, semi-proven and other parcels of Crown reserve land, which have been put up for auction by the Provincial Government in Alberta alone. All these acquisitions have been made on the assumption of certain rates of return on the total acquisition and development costs of these properties. As far as is possible, estimates are made of the future allowables appropriate to the fields in which the purchases are made. Frequently the independent borrows money to develop the lands and in the early days he was permitted to borrow not only for the development, but also for the purchase. Any downward change in any of the allowables, from whatever cause, decreases the rate of return and the yearly revenue derived from the properties. In recent months these allowables have suffered a set back for two different reasons. In January 1958 the Oil and Gas Conservation Board in Alberta adjusted the economic allowable downward and general market conditions have reduced percentage produced of the M.P.R.'s on other fields. This has affected independent companies by reducing the cash throw off normally available for investment in exploratory ventures and has added to the difficulties of financing long term loans on production which require adequate assurance of future marketability of such production. Inevitably, convertible debentures, notes and even common stock will be more difficult to sell to institutions or the public at large.

## THE NEED FOR INCENTIVE TAXATION

Several submissions have been made to public bodies with regard to taxation in relation to the oil industry. In spite of this, it is felt that this review would be incomplete without some further reference to the subject.

Authorities agree that the greater part of foreign investment in the Canadian oil industry has come from the United States. It is also generally

agreed that U.S. tax laws allow a wider participation in the industry and offer more incentives and concessions for the investment of risk capital which has contributed greatly to the growth of the independent oil industry in that country. Some of the factors in U.S. tax law which contribute to this situation are:

- (1) Individuals and corporations whose principal business is not "production, refining or marketing of petroleum" are allowed to deduct their expenditures in searching for oil in computing taxable income. This has had the effect of attracting risk money to the industry especially during periods of high taxation.
- (2) Operators in the United States are granted a more generous method of computing depletion in calculating taxable income with the alternative of using "cost depletion" if it is more advantageous to do so.
- (3) The U.S. operator is allowed to recover most of his costs against income in the United States whereas in Canada, except in certain limited circumstances, the cost of abandoned properties is not allowed as a deduction.

One criticism levelled at our Canadian system of taxation stems from the fact that it places the Canadian operator at a disadvantage vis-a-vis United States competitors, including the major international oil companies based in the United States, in Canadian oilfields. Mr. J. Grant Glassco formerly of Clarkson, Gordon & Co., an expert in this field, has very ably summarized the position in a submission to this Gordon Commission and we include his comments as an appendix. His opinions are borne out by "The President's Materials Policy Commission" under the chairmanship of William S. Paley, which read in part as follows:

"On balance considering all aspects of the income taxes as they apply to the mineral industries it appears that the oil and gas industries receive more generous treatment in the United States than under Canadian law."

In addition to the great advantages that U.S. producers have over their counterparts in the matter of depletion, we would like to point out also the advantages that any marketing and/or refining company operating in Canada has over the Canadian independent producer. Such marketing or refining company is permitted to write off against its refining or marketing profits all exploration and drilling costs with the result that it may be able to enjoy immediately a 33 1/3% depletion allowance on its oil and gas production.

Under similar circumstances but with no refining or marketing profits a Canadian independent oil producer attempting to conduct an exploration program is not allowed to take the advantage of depletion allowance until he has written off his exploration and/or development costs. This may not occur until 100% of the oil has been produced.

## CONTRIBUTION OF THE INDEPENDENTS

While the main objectives of any producer, whether an independent or a major are fundamentally the same, their financial problems and their avenues of approach are radically different. The major companies can borrow money more cheaply, and, because of revenues derived from production elsewhere, they can afford a widespread and costly exploration program aimed at the major discovery.

Whereas the major international integrated oil company must always have due regard for the susceptibilities and policies of other countries where the company has large amounts of capital invested and large reserves, the Canadian independent is only concerned with the affairs of Canada. The Canadian independent has, therefore, the responsibility to present the case from the national point of view. His contribution in this respect is valuable.

The independents in the U.S.A. have made significant contributions to the industry.

	<u>Majors</u>	<u>Independents</u>
Gross crude oil production from 1952 to 1956	62%	38%
Wells drilled from 1952 to 1956	22%	78%
Wildcat drilling during 1952 and 1953	19%	81%

No figures are available to us for the number of discoveries made by independents versus majors. The fact that the independents drilled more than three-quarters of all the wildcat wells would indicate that they probably discovered the greater proportion of new fields.

The contribution of the independent in Canada is as follows:

	<u>Major</u>	<u>Independents</u>
Contributed to Alberta Provincial Crown Sales	\$229,325,209	\$158,183,045
Alberta gross crude production - 1956	76%	24%
Alberta percentage of oil wells - 1956	65%	35%
Wildcat drilling - 1953 to 1956 inclusive	47.3%	52.7%
Oilfields discovered (Alberta) 1930 to 1957	60	46
Gas fields discovered (Alberta)	65	58

We have selected three of the major companies, which:

- (a) In 1956 produced over 70 million barrels of oil or over 49% of light crude produced in Alberta from wells listed in their own names - this does not count wells in which they own an interest but in which their name does not appear; and,
- (b) In 1957 produced over 60 million barrels of oil or 44% of light crude produced in Alberta

We list below the exploratory effort of these three companies during the same period.

<u>Year</u>	<u>Exploratory Wells Drilled by 3 Majors</u>	<u>Total Exploratory Wells by Industry</u>	<u>% of Total</u>
1953	74	477	15.5
1954	65	428	15.1
1955	74	412	17.4
1956	77	478	16.2
1957	89	573	15.3

The independent industry provides an avenue for investment by the Canadian public. It is attractive to them because it gives a greater leverage prospect and proportionate share in a substantial discovery than would be available by investment in major companies. Of the 211 companies traded on Canadian stock exchanges last year only 9 of these were major integrated oil companies or their subsidiaries.

The independent industry also attracts individual investors as partners from the U.S.A. Participation by these investors with major companies is unusual if not actually non-existent. Independent companies because of their size and the personal contact permit such participation on a fairly heavy scale. The independent industry is therefore able to attract finance from outside sources which would not otherwise be available to the industry.

In Canada the competitive presence of the independents not only stimulates activity in areas of the industry where the major companies would otherwise be left alone to conduct affairs, but their presence also permits representation to public bodies, such as this Commission, of a different point of view from the internationally integrated company.

## THE OUTLOOK FOR THE INDEPENDENT PRODUCER

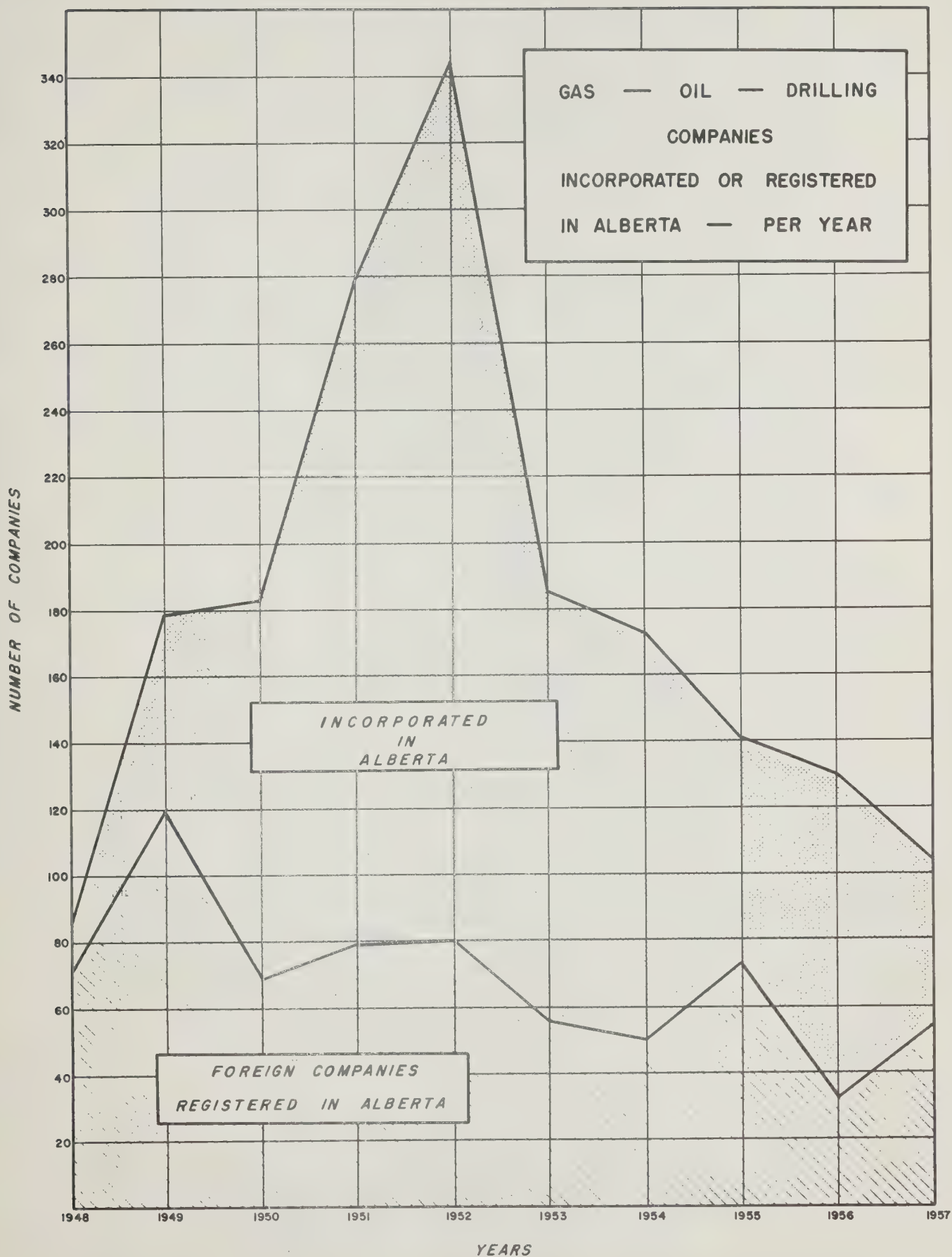
Evidence before this Commission has shown that:-

- (a) 7.4 to 10 billion dollars will be required to finance the oil business between now and 1968.
- (b) 1.3 to 1.5 million barrels of oil can be produced daily by 1963.
- (c) 27 to 50 billion barrels of reserves will ultimately be discovered in Western Canada.

The figures we have presented in this statement show that the independents have taken part in nearly 40% of the investment in Government properties, approximately 25% in production and more than 50% in the number of wildcat wells. The independents have made a major contribution to the industry in Canada. If they are to continue their activities on the same scale the independents must be in a position to attract large amounts of new capital. However there is a possibility that a combination of adverse tax laws; difficulties of financing due to low rate of return; difficulties of obtaining long term finance from Canadian institutions; commercial preference by refining companies to take their own crude from overseas; may lead to the subordination of the independent in the same way that it has done in such places as Trinidad.

We have endeavoured to suggest means by which this situation can be avoided - tax adjustments, both corporate and personal; an increased share of the crude oil market in Montreal; no further changes in the method of proration to market demand; and greater facilities for long term financing by Canadian insurance houses, pension funds and banks.

Backed by such considerations the independent Canadian oil companies have probably a greater chance than ever to take their place in the industry. Land is coming available. Geological and geophysical knowledge has become enlarged and better documented as a result of ever-widening development and exploration. Techniques unknown ten years ago in the industry are now commonplace. Canadian personnel trained in all branches of the oil business are becoming available. It is our feeling that the greater the number of efficient operating units the better the chance of generating new techniques and economies of operation and finding and developing more Canadian oil.





## APPENDIX I

### METHODS OF FINANCING

#### 1. PRODUCTION LOAN FROM CHARTERED BANKS

In 1947 Canadian banks were quite unfamiliar with a technique which had been fully developed as a facility to the independent oil industry in the United States. However in 1949 and subsequently some of the leading chartered banks in Canada set up geological appraisal departments and loans were made to certain independents to enable them to purchase proven oil rights either from the Provincial Government or other parties wishing to sell. Repayments were made out of the proceeds of production from the wells on these properties. These same properties were the specific security for the loan. It should be added that in most cases the company concerned had to "go on the note". Interest varied from  $4\frac{1}{2}\%$  to  $5\frac{1}{2}\%$ . This particular form of loan has not only been of great importance to the independent oil industry, but also to the banks themselves. In the case of one bank alone loans of \$45,000 in the late 1940's had grown to a total of \$20,000,000 in recent years, almost all of which was out to independent companies. Loans are made either on a "term" or "call" basis.

Naturally the "credit climate" of Canada governs the conditions under which these loans are made. For example, the ability to lend for both acquisition and development of proven properties, which existed in the early 1950's, was heavily curtailed during the credit "squeeze" in 1956-57. The banks did their best to assist old customers, but refrained from taking on any new commitments. The rate of interest was high and the payout on loans was reduced from a 60 to 72 month payout to a 30 month payout schedule. Furthermore, except in limited circumstances, the loans were only permitted for the development of properties and no loans were permitted for acquisition costs. This had an immediate restrictive influence on the activities of some of the independent companies. However, this situation has recently improved. Interest is down slightly from its peak ( $5\frac{1}{4}\%$  to  $5\frac{1}{2}\%$ ) and development loans are permitted on a so-called 48 month payout basis.

It is evident that any serious drop in the production forecasts determined on the basis of the best available knowledge at the time that the loan is made seriously upsets the repayment schedule. The company guarantees the loan so that the bank then may have recourse to the other revenues of the company.

## 2. LONG TERM MORTGAGE

The chartered banks, and, except in small amounts, pension funds and the insurance companies of Canada have not so far taken long term mortgages of ten to fifteen years' duration from independent oil companies. The production loan referred to in the previous paragraph is of great temporary convenience. Due to the short term nature of the loans there is a great incentive to convert to a long term mortgage. The ability to do this provides a great stimulus to a growing independent and yet independents have had to resort to foreign countries to do it. The inability to do this combined with the reductions in allowables, for whatever reason, strangles the activity of an independent and results in a period of inactivity or even deace. The big pension funds, the insurance companies and the banks cooperate to do this type of financing in the United States. Ten and fifteen year loans are common, although in recent times they have requested some additional perquisite over and above the straight interest charged on the loan. The same effect has been obtained by some companies by somewhat different methods of financing in European countries.

This would seem to be one avenue through which Canadian financial institutions could take part in the development of our oil industry and it would seem highly desirable that there should be similar facilities in Canada.

## 3. DEBENTURES AND OTHER SECURITIES

Another method of achieving the same objective as the previous two paragraphs is by selling securities to the public. A variety of different terms have been used by financial circles, such as: convertible sinking fund debentures, convertible notes, preferred stock and so forth.

The attached Schedule A shows the comparison between the terms that are offered by financiers to an independent company and those which are offered to the major companies.

The disadvantages over the long term mortgage route are first, the heavy cost of public financing; and second, the necessity of sacrificing equity through convertible features.

#### 4. EQUITY

A study has been made of the various financial structures of the most active independent companies. No general statement can be made. Their financial structures follow no set pattern.



## SCHEDULE A

### LONG TERM DEBT

#### MAJOR COMPANIES

Standard Oil Company (N.J.)	25 years	3 1/8% S.F. Debentures due March, 1977	\$25,000,000
Imperial Oil Limited	20 years	3 5/8% S.F. Debentures due February 1, 1975	\$44,264,000
Standard Oil Company of Ohio	26 years	4 1/4% S.F. Debentures due January 1, 1982	\$25,000,000
Union Oil Company		3 1/4% Convertible Debentures due 1967 to 1981	\$120,000,000
Tidewater Oil Company	30 years	3 1/2% S.F. Debentures due April 1, 1986	\$50,000,000
Shell Oil Company	25 years	2 1/2% S.F. Debentures due 1971	\$104,158,000
British American Oil Co. Ltd.	20 years	2 7/8% S.F. Debentures due 1966	\$12,000,000
	20 years	3 1/2% S.F. Debentures due 1974	\$20,000,000
	20 years	5 1/4% S.F. Debentures due 1977	\$20,000,000

#### JUNIOR COMPANIES

Home Oil Company Limited	15 years	5 3/4% Secured Convertible S.F. Debentures, due December 15, 1971	\$6,500,000
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# JUNIOR COMPANIES (continued)

Western Decalta Petroleum Limited	15 years (actual payout 7 years)	5% Secured Convertible S.F. Debentures	\$4,500,000
Merrill Petroleum Limited	10 years	5½% in Canada 5¼% in U.S. - S.F. Debentures with Warrants attached	\$8,000,000
Medallion Petroleums Limited	10 years	* 1% - 5% Debentures due 1962	\$1,500,000
Devon Palmer Oils Ltd.	10 years	5½% Convertible S.F. Bonds due 1964	\$1,100,000
	10 years	5½% Convertible S.F. Debentures due 1963	\$500,000
Cree Oil of Canada Ltd.	10 years	5% S.F. Debentures due 1966 Warrants attached	\$6,000,000
Great Plains Development Co. of Canada Ltd.	15 years	* 1% - 4% Notes due 1965	\$7,054,500
Husky Oil & Refining Ltd.	15 years	5 1/8% S.F. Debentures	\$3,000,000
Dome Exploration (Western) Limited	12½ years	4¼% Notes due 1963	\$7,721,500

\* In reality a form of equity financing.

## APPENDIX II

### THE TAXATION OF CANADIAN OIL DEVELOPMENT COMPANIES

Mr. Glassco states:

"An analysis of the facts suggests that this general complaint is based upon several different underlying factors. One important consideration is that the terms of the United States tax laws, particularly within the past five years, have offered incentives and concessions to their taxpayers which go considerably further than any similar concessions available to Canadians. Thus, wealthy individuals and corporations with profits subject to taxation at very high rates have been able to reduce their United States taxable incomes, and thus save large amounts of tax, by making expenditures in Canada in oil exploration or development. Much of the money at risk was tax money, particularly in years when excess profits taxes applied in the United States.

"Another major difference between the respective situations of Canadian and United States operators lies in the varying methods adopted by the two countries in granting allowances for depletion. There can be no doubt that the Canadian allowances are considerably less generous than those available under United States law. A principal objection to the Canadian system is that it requires the writing off of exploration and development expenses before arriving at the figures upon which the depletion allowance is calculated. As a result, once substantial production is reached, every additional dollar spent on exploration and development will serve to reduce the depletion allowance available. Thus, at a certain point in the program of a Canadian operator, the method of granting depletion introduces a strong incentive to stop exploration and development. In contrast to this, the United States system provides a continuing incentive to exploration and development because it is based on gross income (with a limitation based on net income before deducting the expenses of unsuccessful exploration), but with an automatic option of cost depletion when it is the more favourable.

"As far as Canadian taxation is concerned, operating results in Canada of both Canadian and United States operators receive identical treatment. The advantage, therefore, in what is referred to as improving his "competitive position" lies entirely in the manner in which the United States operator is able to reduce the taxes which he would otherwise pay in the United States. This observation relates particularly to the exploration and developments stages and it should be added that, while these initial advantages are never lost, the so-called advantage ceases once the operator has reached the point where income from production has absorbed all the initial costs. From that point forward, both operators will be on an equal footing.

"In an attempt to illustrate the extent of the possible variations calculations have been made in respect of an assumed program having an average degree of success and conforming in other respects as closely as possible to the typical experience in the Alberta oil fields. This assumed program covers a 10 year period and the depletion to which it would become entitled is as follows:

(a) Allowable for United States tax purposes	\$3,729,000
(b) Allowable under Canadian law to a company engaged only in exploration and production	\$1,463,000
(c) Allowable under Canadian law to a company having substantial income from marketing or refining	\$1,849,000

"In calculating the actual taxes payable, the whole range of variation is illustrated by the several assumptions made. Thus, the taxes will vary as shown hereunder, depending upon where and by whom this typical program is carried out.

(a) A United States company operating entirely within the United States would pay United States taxes of	\$682,000
(b) A United States company which carried out the same program in Canada, but which had other United States income, would pay combined United States and Canadian taxes on the income from the program of	\$900,000

- (c) A Canadian company having substantial marketing income, but no other production income, carrying out the same program in Canada would pay taxes on the income from the program of \$1,195,000
- (d) A Canadian company having no income from marketing or refining, etc., would pay taxes of \$1,376,000

"From the above it will be clear that the best possible tax deal for the United States operator will not be obtained by operating in Canada, but providing he has other income taxable in the United States, he is bound to fare better tax-wise than a Canadian operator in any circumstances. The above calculations are based on only one set of assumptions. In practice there will be a fairly wide degree of variation, both as to the type of program carried on by different operators, and as to the degree of success achieved. However, alternative calculations which were made assuming a much greater emphasis on wildcatting, and also calculations placing much greater emphasis on developing proven acreage, showed somewhat different patterns without, however, in any way changing the basic conclusions.

"Among the suggestions for the improvement of the Canadian system, the one which appears to merit most serious consideration is the proposal to change the basis of the depletion allowance. If the allowance were changed to a percentage of gross revenue, or alternatively a percentage of net revenue before the deduction of any exploration and development expenses, the incentive value would be enhanced and the system should become more logical and desirable, in that the incentive to cease exploration when production was secured would be removed.

"A second important change which should receive consideration is to make available cost depletion as an alternative where the percentage depletion proves insufficient to cover the actual costs. Such a move would have obviously important results and improve the so-called competitive position

of the Canadian operator, particularly in the case of high cost wells. Consideration might also be given to finding a better method of enabling the operator to write off against income the costs of unproductive and abandoned property, the present provision in this respect being extremely limited.

"In discussing proposals to extend cost depletion and broaden the range of write-offs available in respect of unproductive property, however, it is important to recognize that any such change will have an immediate and material effect upon the prices at which oil properties may change hands. Unless appropriate safeguards are developed, there would be an inevitable tendency to bid up the prices of oil properties, and in such circumstances the treatment of the resulting profits in the hands of vendors would have to be considered. It is fair to say that unless some restraint was imposed in this connection, a serious loss of tax revenue would undoubtedly occur.

"The over-all purpose which our method of taxing the oil industry should attempt to secure is that the operator should have a reasonable assurance that all of his costs will be deductible from the revenues which arise from his operations. In addition, there should be some recognition of the special risks and hazards inherent in this industry and it would obviously be desirable that, so far as possible, the incentives offered should apply in their fullest form where the risks are greatest.

"It would appear that in its present form our Canadian tax system falls short of these desirable objectives in several important ways, and it would further appear in the public interest that this situation should be corrected as quickly as possible. As has been pointed out, however, there is no simple solution, and before any decisions are made as to specific changes in the law, there is need of most careful study of the subject by competent persons. It is suggested, therefore, that the most effective way of bringing about a desirable revision of our laws will be to set up a special body, in committee or commission form, consisting of from three to five highly qualified individuals, and to set such committee the task of examining the problem in detail. Obviously the views of those engaged in various capacities within the industry will be of extreme importance and it is believed that by this method a greatly improved taxation system can be developed. This will have obvious advantages from the point of view of Canadian investment in the further development of the petroleum industry in Canada.

"One final suggestion is made regarding the form of incentive offered by our tax laws. The extent to which incentive tax concessions should be made available to non-resident investors is essentially a matter of policy and the technical structure can be adjusted to carry out whatever results may be intended. There is danger, however, that without special safeguards some incentives made available to Canadians and non-residents alike may, as a result of foreign taxation, merely transfer the benefit to the treasury of the foreign country. Our three-year exemption for new mines is a case in point and the benefit of any reduction in Canadian taxes which a United States investor enjoys will probably, under the present rules, be transferred to the United States Treasury through a reduction of the tax credits allowable to the United States taxpayer."



## APPENDIX III

### THE PURCHASE OF PROVEN, SEMI-PROVEN OR PRODUCING PROPERTIES

Oil, in common with other mineral resources, is a "wasting asset", and certain standards have been set for the evaluation or the purchase price of such an asset. Probably Hoskold is one of the most acceptable authorities. Using his formula a satisfactory purchase price may be deduced when the asset yields a yearly return of 8% after taxes on the invested capital, and after providing for:

- (a) The return of all the original investment at the end of the life of the property.
- (b) The payment of 4% interest per year on the principal investment throughout the lifetime of the property - not on a system of diminishing balances.

In the oil business in Western Canada, reference is sometimes made to buying property on, what is rather loosely termed, a "five" or "six" or a "seven year payout". Usually the term "payout" refers strictly to the return of the company's investment, without interest, over the period indicated. To obtain an identical return using the above assumptions in the Hoskold formula and mid-1957 allowables a calculation will show that a "five year payout" at the Pembina Cardium sand reservoir (15 year life) is equivalent to a "seven year payout" at the South Sturgeon Lake D3 reservoir (25 year life).

It is obvious that all companies try to improve on these standards and the current much reduced allowables have stretched the "payouts" made in 1956 and earlier to a point where they no longer fall within the projections considered reasonable under the Hoskold formula.





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